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# Comments on Edgar Olsen's Is Rent Control Good Social Policy


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# COMMENTS ON EDGAR OLSEN'S "IS RENT CONTROL GOOD SOCIAL POLICY?"*

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Olsen's analysis is primarily a critical survey of *positive* analyses of rent controls—it describes how they work and their impact upon the economy.[1] I would like to begin by viewing Olsen's main findings through the lens of a systematic *normative* conceptual framework provided by economic theory. Then I shift from the positive and normative analysis of rent controls to the public choice question of why they are enacted in the first place.

## WELFARE ECONOMICS AND RENT CONTROLS

The normative framework used by most economists to evaluate public policy is "welfare economics," the branch of economic theory concerned with the social desirability of alternative economic states. The centerpiece of welfare economics is the so-called Fundamental Theorem, which states that as long as producers and consumers act as perfect competitors, then under *certain conditions* (discussed later), the economy's resources will be allocated efficiently, without any need for centralized intervention (shades of Adam Smith's "invisible hand"). To the extent that these certain conditions do not hold in a given situation, then government intervention may enhance efficiency. In addition, the theory of welfare economics indicates that even if the allocation of resources is efficient, government intervention may be necessary if the distribution of income is inconsistent with society's ethical beliefs.[2] However, such redistributions should be undertaken in a way that minimizes any detrimental effects on efficiency.

The crucial question thus becomes, what are the "certain conditions" required for the Fundamental Theorem to hold. Very briefly, markets may fail to allocate resources efficiently under the following

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1. Edgar O. Olsen, *Is Rent Control Good Social Policy?*, 67 CHI.-KENT L. REV. 931 (1991).

2. Even though distributional and market failure problems provide opportunities for government intervention in the economy, they do not require it. The fact that the market-generated allocation of resources is imperfect does not mean that the government is necessarily capable of doing better.

conditions[3]:

*Market power.* When some firms have the ability to raise the price of a commodity above the incremental cost of its production, an inefficiently small quantity of resources will be devoted to that good.

*Public goods.* Consider a commodity such as national defense. The fact that one person benefits from the presence of the armed forces does not prevent anyone else from doing so simultaneously. Goods like defense, which are non-rival in consumption, are referred to as public goods. People have an incentive not to reveal a public good's true worth to themselves—they can free ride on other people's expenditures. A market mechanism therefore may not lead to sufficient resources being devoted to such goods.

*Externalities.* In a properly functioning market, the price of a commodity reflects the costs of all resources that were consumed in its production. An externality refers to a situation in which individuals or firms may use resources for which they do not have to pay. The classic example is pollution. As a consequence, the price of the commodity is too low relative to its social costs, and the market provides an inefficiently large quantity of the commodity. Externalities can also be positive—the behavior of one entity has a direct positive effect on the welfare of another. In this case, the commodity will be under-provided by the market.

*Asymmetric Information.* The competitive model assumes that information is perfect, or that in situations of uncertainty, all agents share the same degree of uncertainty. However, when information is asymmetric—one party to an exchange knows more than the other—markets may not operate efficiently. For example, a sub-optimal amount of health insurance may be provided because insurance companies have poorer information about an individual's health status than the individual herself.

In summary, whenever economists suspect that something is amiss in a market, then, like the police chief in the film CASABLANCA,[4] they round up the usual suspects: market power, public goods, externalities and asymmetric information. If none of these is present, then there is no reason to believe that government intervention will enhance efficiency.

When I view Olsen's paper through the lens of welfare economics, what it tells me is that in rental housing markets, when we interrogate each of our suspects, no one turns up guilty. In the long run, Olsen argues that apartment owners appear to earn competitive rates of return,

3. For a more complete discussion, see Francis M. Bator, *The Anatomy of Market Failure*, 72 Q.J. ECON. 351 (1958).

4. CASABLANCA (Metro-Goldwyn-Mayer 1942).

so market power is not an issue. Apartments are rival in consumption, so no public goods problem is present. *If* rent controls lead to more owner-occupied housing and *if* owner-occupation *per se* produces benefits to other members of society, then rent control may be viewed as a way of addressing externalities. But as Olsen argues, there is no reason to believe that such externalities exist, and even if they do, rent control is an inefficient way to encourage owner-occupation.

Finally, there is no reason to believe that there are sufficiently serious informational asymmetries to impede the workings of this market. In short, Olsen's findings imply that there is no efficiency basis for government intervention in this market.

Of course, as noted above, the theory of welfare economics suggests that efficiency may be sacrificed to achieve a fairer distribution of income. However, Olsen shows that this caveat does not save rent control—at least if "fairer" means a more egalitarian distribution of income—because the benefits of rent control do not flow to people with the lowest incomes. Moreover, because the evidence cited by Olsen shows that rent control distorts people's consumption bundles, it is an inefficient way to subsidize the people who do benefit from the program.

Before leaving welfare economics, it is important to note that as an ethical system, its distinctive characteristic is its concern with results. Situations are evaluated in terms of the allocation of resources, and not in terms of the *processes* used to determine that allocation. Hence, one may sometimes reject a policy that enhances efficiency and/or income equality if one's ethical views suggest that the process involved is undesirable. Conversely, one may accept a policy that is inefficient and inegalitarian in its effects if the process somehow is viewed as particularly desirable. Olsen's analysis suggests that to the extent that rent control raises issues beyond the scope of traditional welfare economics, they work against the policy. Specifically, he argues convincingly that a policy that redistributes income away from people simply on the basis of their occupations (and no other criteria, such as ability to pay) is undesirable.

## WHY ARE THERE RENT CONTROLS?

With admirable brevity and clarity, Olsen's paper answers the question posed in its title. Is rent control good social policy? The results of positive economic analysis reported in the paper together with the normative framework of welfare economics indicate that the answer is a resounding no. This immediately leads to another question: Why are rent controls so popular? While the literature on the effects of rent controls is voluminous, not much has been written on why they are enacted in the first place.

One possibility is that policy makers simply don't understand the consequences of rent control. While one should never underestimate the importance of ignorance, it is worthwhile to speculate on whether rent control might be the outcome of a process in which self-interested and well-informed actors attempt to maximize their own well-being.

In a model suggested by Dennis Epple,[5] the reason that rent controls come into existence is that governments cannot pre-commit to a policy of never having rent controls. In his model, rational residents of a town realize that if rent controls are ever imposed, the effective housing supply will contract, and if they ever have to leave their current dwellings, they will find themselves unable to find an apartment, or the price of an apartment may be relatively high. Hence, *ex ante*, it is in their interest to vote to commit against rent control. However, in the absence of the ability to make such a commitment, then *ex post* it may be in the interests of people to vote for rent control. And realizing this, suppliers will contract the supply of housing in anticipation of the imposition of rent controls, leading to a lower equilibrium level of welfare.

Epple's intriguing result is an example of a more general phenomenon referred to as the "time inconsistency of optimal policy." Unless the government can *credibly* promise not to renege, it cannot conduct the fully efficient policy. If Epple is correct, then acting upon the policy implications of Olsen's analysis will require more than simple education. Rather, it requires the development of some mechanism for governments to make their promises about rent control credible. This would appear to be a fruitful area of collaborative research for lawyers and economists.

5. Dennis Eppel, Rent Control with Reputation: Theory and Evidence (1988) (on file with *Chicago-Kent Law Review*).